

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Third Quarter of 2010 through the Fourth Quarter of 2014

The national economy has been expanding since the third quarter of 2009, but it could do better. Since that time, real output has grown faster than 3.0% in just two quarters. In order for it to shift into higher gear, consumers must be willing to spend more freely. Unfortunately, in the U.S. economy, where the consumer is king, the king is not in the mood to spend. The University of Michigan consumer sentiment index hit a record low of 63.8 in 2008. Two years later it was 71.1, which was still well below average.

Consumers have several reasons to be cautious. The lack of jobs remains one of the most frustrating features of the economy. Well over a year after the official end to the recession, a couple of measures reveal why job seekers are disappointed. As of October 2010, the nation's unemployment rate was near 10% and the underemployment rate was about 17%. Consumers have also experienced a stretch of tight credit and watched their household finances deteriorate. For example, after peaking in 2007, U.S. household net worth declined by \$10.6 trillion by 2009. One of the reasons for the drop was the housing price collapse. Since 2006, the average price for an existing home in the U.S. has declined nearly 20.0%.

Consumers and businesses are stuck in an economic "Catch-22." Consumers will spend more when they regain confidence in employment, but firms will not feel very confident in hiring more people until the economy starts growing faster. The virtuous circle necessary to drive spending and employment up strongly together has yet to develop. The need to hire appears to exist; productivity growth has been strong, suggesting those with jobs could use some additional help. Both consumers and businesses had concerns about the expiration of the 2001 federal tax cuts. Fortunately, this matter was settled late last year. It is hoped the end of this uncertainty will help transform the vicious cycle into a virtuous one where hiring and spending reinforce each other.

Another positive is the nation's long-suffering housing sector should improve in 2012. After five tumultuous years, housing prices are expected to begin rising again. New housing starts, which had fallen below one million units since 2008, are projected to clear 1.2 million units next year. Sales of existing homes should once again top five million units in 2012.

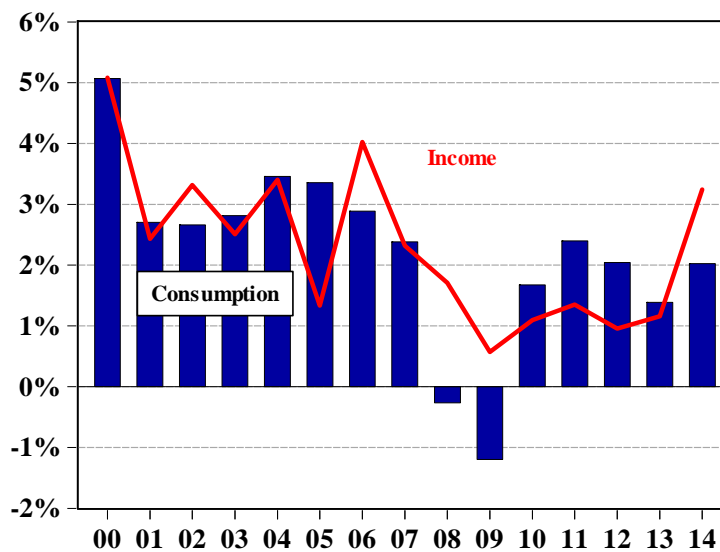
The road back to economic prosperity will be gradual. National nonfarm employment is forecast to grow 1.0% this year and 1.8% annually in the remaining years of the forecast. At that pace, it will take until 2014 to regain all of the jobs lost since the 2008 peak. The unemployment rate is expected to be 7.9% in 2014, which is above the level consistent with full employment. Real disposable income should gradually improve, and this will help real consumer spending to slowly expand. Consumers' moods should be lifted by anticipated growth of household net worth. Business investment was strong in 2010, but this did not translate to much hiring because most companies were spending to increase the efficiency of their operations, not to increase capacity. It should be more balanced in the future, and the good news is companies have lots of cash on hand to make these investments.

No doubt some will be disappointed with the recovery. Indeed, things could be better. However, the economy is moving in the right direction. And even the smallest steps forward puts the worst downturn since the Great Depression further behind us.

SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: It appears real consumer spending made a positive turn in 2010, but the recovery will be gradual. Consumers tightened their belts during the recession, causing spending to shrink 0.3% in 2008 and 1.2% in 2009. This period is the only time during the last half century spending has declined in two consecutive years. As a result, this single-largest component of GDP was actually a drag on the U.S. economy. It is estimated real spending grew 1.7% last year, which made it a contributor to real GDP once again. While welcome, this growth is low by historical standards. One of the reasons for this low growth is after having come through the worst downturn since the Great Depression, consumers are understandably cautious. Their mood shifts can be mapped by the changes in the University of Michigan consumer sentiment index. After peaking at 95.2 in 2004, the index drifted down to 85.6 in 2007. It then plunged to 63.8—its lowest level on record in 2008. It increased slightly to 66.3 the next year, but it was still about 20 points lower than the 50-year average. Consumers have a right to be nervous given the recent drop in household net worth, tight credit, and the weak job market. After peaking in 2007, U.S. household net worth declined by \$10.6 trillion by 2009. Over this period it dropped from being over six times disposable income to under five times disposable income. The ratio of monthly financial obligation to disposable personal income slipped from almost 19% to 18%, as credit dried up and consumers reined in spending. And despite the recession being officially over since June 2009, the unemployment remains near 10%. At present, consumers' hesitancy to spend and businesses' reluctance to hire are reinforcing each other. Consumers and businesses are stuck in a vicious cycle. Consumers will spend more when they regain confidence in employment, but firms will not feel very confident in hiring more people until the economy starts growing faster. The virtuous circle necessary to drive spending and employment up strongly together has yet to develop. Real consumer spending accounts for 70% of GDP, and it has dampened the prospects for GDP growth. Firms have been holding on to their cash, waiting for market and public policy uncertainties to be resolved before making new and hard-to-reverse investment and hiring decisions. A major uncertainty had been the expiration of the 2001 federal tax cuts. It was resolved late last year. This resolution will help turn the vicious cycle into a virtuous one. However, it will take time for the current cycle to reverse direction. Real consumer spending is forecast to increase 1.7% in 2010, 2.4% in 2011, 2.0% in 2012, 1.4% in 2013, and 2.0% in 2014.

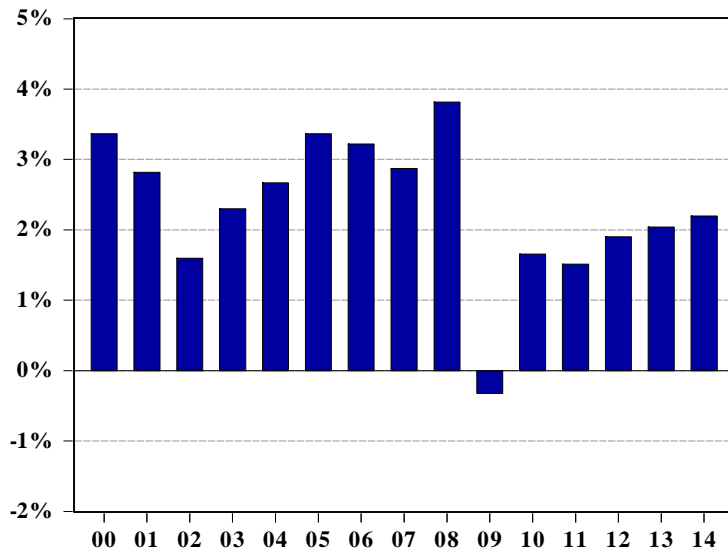
U.S. Real Consumption and Disposable Income Growth



Source: IHS Global Insight

Inflation: Inflation is expected to remain tame over the forecast period. Indeed, core inflation (total inflation less food and energy) barely has a pulse. It was reported that core inflation in October 2010 was just 0.6% higher than in the previous October. The change is the smallest 12-month increase since the inception of this concept in 1957. The primary reason for the low core inflation is low employment costs. It is estimated these costs grew just 2.0% in 2010, which is virtually the same as in 2009. Interestingly, one part of these costs, wages and salaries, actually grew just 1.6%, the result of the slack labor market. Other components grew faster. Benefits, fueled by health insurance increases, advanced

Consumer Price Inflation



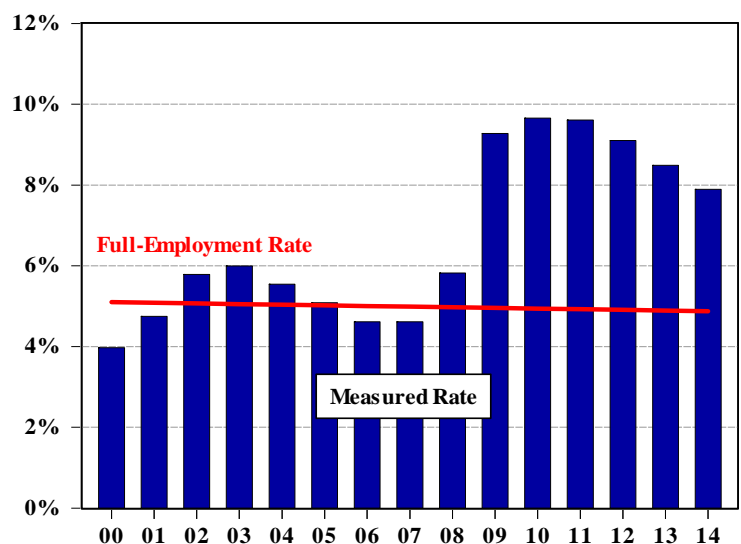
Source: IHS Global Insight

2.6% last year. Health insurance increased nearly 5.0%. Employment costs are expected to simmer slowly over the forecast period, but not boil. As the unemployment rate gradually retreats, employment costs are forecast to grow 2.0% this year, 2.1% next year, 2.3% in 2013, and 2.7% in 2014. Core inflation grows slightly slower. It is expected to be 1.3% in 2011, 1.7% in 2012, 1.9% in 2013, and 2.2% in 2014. Adding food and energy prices back into the core gives overall consumer inflation. It is forecast to be 1.5% in 2011, 1.9% in 2012, 2.0% in 2013, and 2.2% in 2014. This measure's slightly faster pace compared to core inflation is caused by sporadic boosts in food and energy prices. For example, food prices are expected to jump 2.4% in 2011 after

being almost flat the previous year. Food inflation is well below 2.0% in the next two years. Energy prices, which increased 9.1% in 2010, are forecast to grow just 1.6% in 2011. However, energy prices recover after next year, growing 5.0% in 2012, 3.7% in 2013, and 2.6% in 2014. Part of the reason for these gains is gasoline prices are projected to be \$2.96 per gallon in 2011, \$3.12 per gallon in 2012, \$3.24 per gallon in 2013, and \$3.34 per gallon in 2014. In turn, these gasoline prices reflect the rise in oil prices from \$78.67 per barrel in 2010 to \$96.27 per barrel in 2014.

Employment: Saying the U.S. labor market is telegraphing mixed signals is an understatement. October's job report was solid, although not spectacular. According to initial estimates, private payrolls climbed by 159,000 jobs—the fourth consecutive month of 100,000-plus gains, as well as the 10th consecutive month in the black. The data showed private payrolls have climbed by 1.12 million since December 2009. Despite these gains, the unemployment rate remained at 9.6%, as both household employment and the labor force retreated. Expectations were whipsawed the following month. Most economists were anticipating total (private and government) nonfarm payrolls to grow by well over a 100,000 jobs in November. Unfortunately, the economy failed to deliver. Instead, it managed to eke out just 39,000 jobs in November, and the unemployment rate increased to 9.8%. One of the biggest surprises was the 28,000-job decline in retail employment at a time when establishments were expected

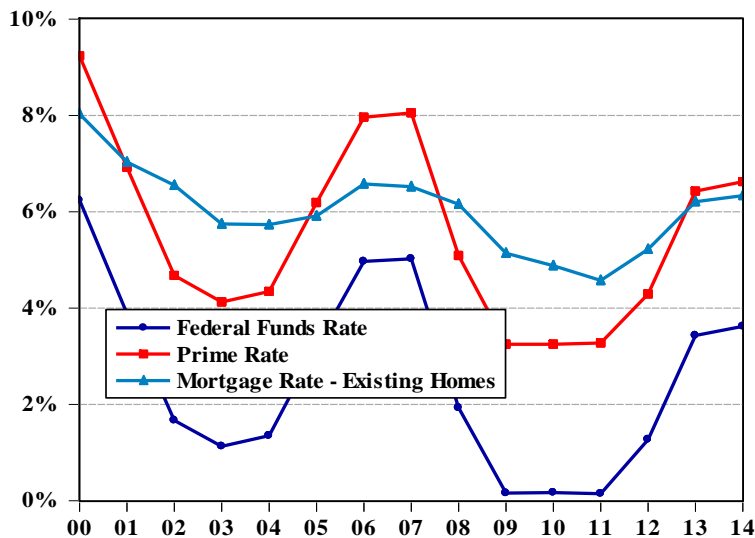
U.S. Civilian Unemployment Rate



Source: IHS Global Insight

to be hiring for the holiday shopping season. While some have tried to put a positive spin on the labor situation, November's report reinforces the outlook for a drawn out job recovery. National nonfarm employment is expected to expand 1.0% in 2011 and 1.8% in each of the remaining years of the forecast. At this clip, nonfarm employment does not surpass its previous peak until early 2014 and the unemployment rate takes even longer to recover. It is expected to be 7.6% at the end of 2014, which is over 2.5 percentage points higher than it was at the start of the recession and well above the threshold consistent with full employment. Due to the gradual labor recovery, employment costs will grow slowly over the forecast period.

Selected U.S. Interest Rates



Source: IHS Global Insight

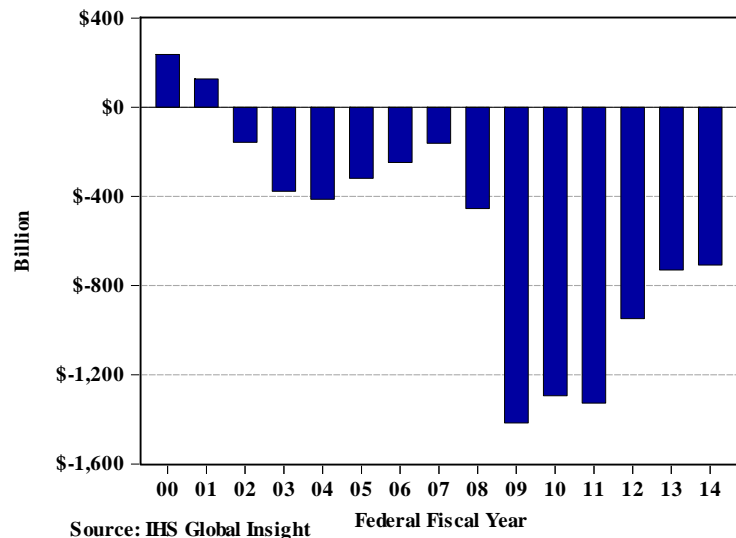
Financial Markets: The economic growth outlook is worse than the Federal Reserve has been assuming, and the deflation risks are greater. In response, the Fed launched a new \$600-billion program of Treasury purchases at its November meeting. This move had been largely anticipated. The biggest effects of this second round of quantitative easing—driving down long-term interest rates and the dollar—are probably already in the market, so it is not expected to give a major boost to growth. But it is, at present, the only policy game in town. Chairman Bernanke's plan goes as follows. Purchase \$600 billion worth of longer term Treasury bills by raising the reserves of member banks. This move drives the price of these financial

instruments. Since prices and interest rates move in opposite directions, longer term interest rates should decline. Ordinarily such a move would fuel inflationary pressures because banks would lend the increased reserves and this would increase aggregate demand. However, there are several reasons Chairman Bernanke believes inflation will not be a problem. First, banks have been sitting on reserves, not lending them. According to the Federal Reserve Bank of New York, member banks have nearly a trillion dollars in excess reserves. Second, there is enough idle capacity in the economy available to supply any increase in demand. Third, the Federal Reserve can tolerate a little inflation because it would help regain the use of other policy tools. For example, the federal funds rate is virtually zero, so it cannot be lowered further to help the economy. Higher inflation would allow more room to move this bellwether short-term rate. Indeed, this forecast assumes the central bank will not move interest rates until March 2012. Fourth, with inflation low and the economy soft, the Federal Reserve is worried about deflation. Fifth, the central bank believes it has the tools necessary to contain inflation if it does start to heat up.

Government: As the November 2010 national economic forecast was being prepared, Congress had not dealt decisively with the expiring provisions of the *Economic Growth and Tax Relief Reconciliation Act of 2001*. Several assumptions were made regarding fiscal policy. All of the tax cuts would be extended on a temporary basis. It was assumed tax increases for high earners would be delayed until 2012. On December 17, 2010, President Obama signed the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* into law. The bill contained some of the following provisions: a two-year

extension of the Bush-era individual income tax cuts; a temporary fix to the Alternative Minimum Tax; an extension of the research and development credit; and an expanded incentive for business investment in the form of 100% upfront depreciation in 2011 for equipment and software. The “Making Work Pay” tax credit expired in 2010. However, there is a one-year reduction in the employee Social Security contribution rate of two percentage points. In the state and local government sector, tax revenues are down sharply, but beginning to stabilize. Federal support for current spending has been extended through \$26 billion in additional aid, and support from the initial ARRA is still coming through. The outlook for the state and local government sector calls for roughly flat spending and future employment declines.

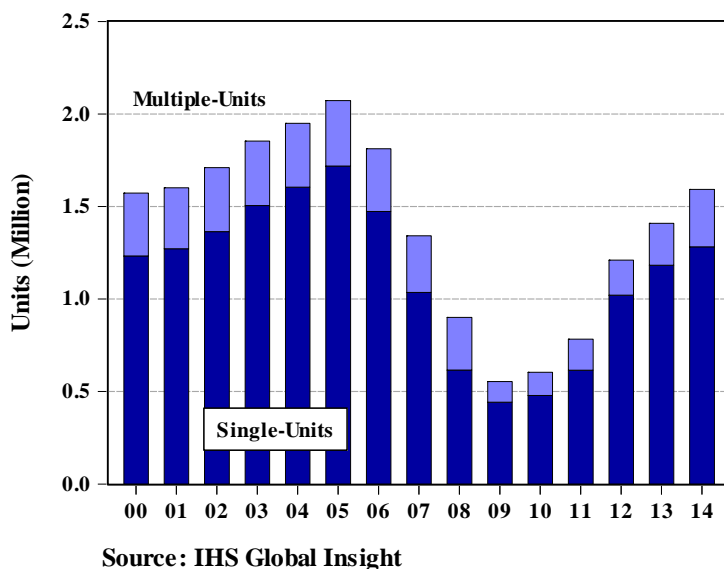
U.S. Federal Government Surplus Unified Basis



Housing: Conditions in the housing market remain poor. Housing starts fell to their lowest level in 18 months in October, as multi-family starts plunged. The news on permits was not as bad as for starts. Single-family housing permits—perhaps the best indicator of housing activity—edged slightly higher after six straight declines. Multi-family permits were essentially flat. Existing home sales improved in August and September, but this market remains extremely weak. The Pending Home Sales Index slipped 1.8% in September, while the Mortgage Bankers Association’s Purchases Index has remained flat since May, indicating that existing home sales are unlikely to have improved in October and November. New home sales were also stuck near the bottom in September. Real spending on residential fixed investment,

boosted by the homebuyers’ tax credit, jumped 26% in the second quarter. But in the third quarter, it gave these gains back, tumbling 29% to its lowest level since the first quarter of 1983. As a share of GDP, it fell to a postwar low. Home prices fell in nearly half of U.S. metropolitan areas during the third quarter, according to the National Association of Realtors, more evidence that the market is losing steam without government tax credits. The seasonally adjusted homeownership rate slipped 0.2 percentage point, to 66.7%—its lowest reading since the second quarter of 1999. The key for housing going forward is employment growth. New jobs will require that new homes be built nearby. More important, the household

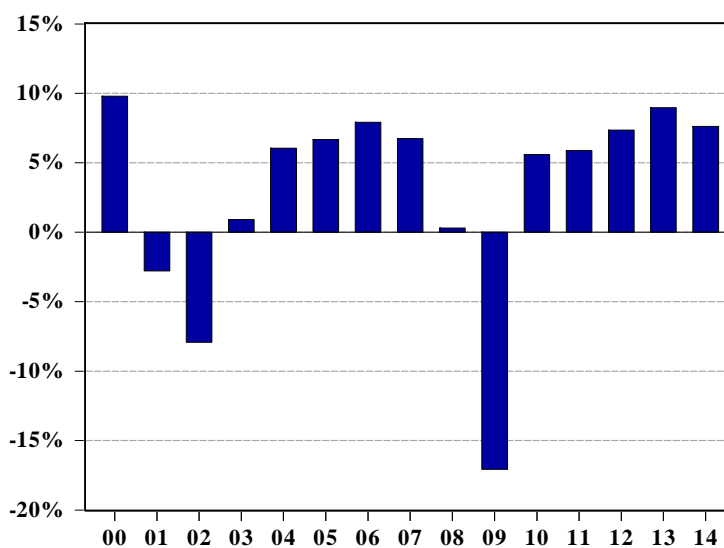
U.S. Housing Starts



formation rate will pick up once job growth takes off. Increases in the household formation rate will then reduce the housing glut, which will stimulate new construction. Overall, the economy is expected to add about 900,000 jobs during 2010, followed by 1.8-million more in 2011 and 2.6-million more in 2012. These jobs will help housing starts bounce back from a postwar low of 554,000 units in 2009 to 604,000 units in 2010, 783,000 units in 2011, and 1.21 million in 2012. Housing prices are projected to drop further because the foreclosure rate is still rising and the housing glut remains near a record high. The Federal Housing Finance Agency house price index (purchase only) should fall another 9% from its second-quarter 2010 level, hitting bottom in the first half of 2011. The 30-year fixed interest mortgage rate is expected to remain low by historical standards for quite a while. It should stay below 5.0% until the second half of 2012. Also, this forecast assumes that the recent freeze on foreclosures by some banks reduces sales by about 200,000 units (annual rate) in the fourth quarter, but raises sales by a corresponding amount in the first half of 2011, as banks lift the freeze.

Business Investment: The forecast for overall business investment masks big differences in the outlooks for its components. Real nonresidential fixed investment is expected to increase 5.9% this year, 7.3% next year, 9.0% in 2013, and 7.6% in 2014. However, a closer look reveals how growth will vary by sector. Healthy corporate balance sheets, low financing costs, order backlogs, and the need to replace aging equipment should keep equipment and software (E&S) investment humming for a while. However, since some categories such as agricultural and construction equipment have been climbing at unsustainable rates, and because demand for high-technology equipment appears to be slowing, growth is expected to be moderate. The forecast is for broad-based, double-digit growth in E&S investment during 2010 and 2011, but “only” 9% growth in 2012, adding about 0.8 percentage point to GDP growth on average during these three years. The composition of spending is anticipated to change. Spending on information equipment and software, which accounted for 60% of E&S investment at the end of 2009, should account for about 51% by the end of 2013. Transportation equipment’s share, on the other hand, is projected to nearly double during these years, from 8% in 2009 to 15.5% in 2013. The future for structures is not as bright. The outlook for nonresidential structures is for another year of painful declines. Spending on nonresidential structures is expected to hit bottom in the fourth quarter of 2011. The decline is broad-based and deep. Manufacturing should plummet 31% in 2010 and 20% in 2011. Commercial and healthcare is projected to drop 26% in 2010. “Other structures” (which includes education, recreation, religious, and lodging structures) should also drop 26% in 2010. Real spending declines in structures moderate from 13.8% in 2010 to 6.7% in 2011.

Real Business Investment



Source: IHS Global Insight